Economic Viewpoint
Desjardins Economic Studies
www.desjardins.com/economics
August 27, 2014

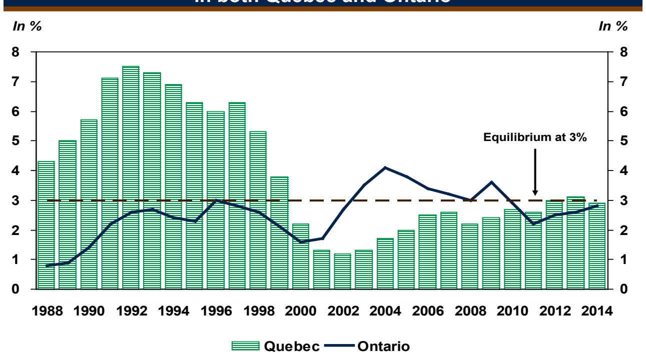
The rental market is doing fine in Quebec and Ontario

In recent years, the booming condo market has captured the attention of the housing sector. Now that it has swung into a surplus position, and construction of this type of housing pulled back last year, the traditional rental market is garnering greater interest. While the vacancy rate is close to the balance threshold of 3% in Quebec, pressure is being felt on both the supply of, and the demand for, rental housing. Now that property ownership is so expensive, even out of reach for some households, many of them are opting to rent. Demand for new apartments is holding steady, encouraging developers to turn to this type of construction. In short, while it is not bubbling over, this market is active in many respects. An analysis of recent trends will give us a better idea of the challenges and outlook for conventional rental apartments.

A MARKET THAT IS GENERALLY BALANCED

The rental market generated considerable commentary in the early 2000s. Many cities in Quebec and Ontario suffered a severe shortage of units in those days, with the vacancy rate nearing 1% in both provinces. Subsequently, lower mortgage rates promoted home ownership, especially for young households, a situation that moderated demand for rental apartments. In the past 10 years or so, the vacancy rate has gradually climbed in Quebec (graph 1) and is now close to the equilibrium level of 3% (see box 1 on page 2). But demand is starting to firm up, because home ownership has now exceeded the grasp of many people. In recent years, soaring prices and the reduction of the maximum amortization period from 30 years to 25 years for mortgage loans with a down payment of less than 20% have shrunk the pool of buyers considerably. Fewer new homeowners, more renters—that is the main reason why the wind has shifted to the rental market.

Graph 1 – The rental housing vacancy rate is close to equilibrium in both Quebec and Ontario



Sources: Canada Mortgage and Housing Corporation and Desjardins, Economic Studies

Growing demand is fuelling starts of apartment buildings, which surged by 20% in Quebec last year. Similar growth has been observed in the first half of 2014. But developers need to show some discipline in this new growth phase. We must keep in mind that the late 1980s and early 1990s were characterized by major surpluses. The period of excess building that came before that, and the drop in demand due to tough economic times, drove the market into a surplus position that lasted 10 years or so. An excessive supply combined with tumbling demand caused by a severe recession left the rental market in dire straits at that time.

The current expansion phase is different. Construction was very limited during the first decade of the 2000s, since condo apartment projects were more profitable than rental buildings. But the attraction of that market has faded and it is going through an adjustment period: condo sales are proving to be more problematic for certain projects, increasing the risk for developers. At this point, the move back to the rental market seems to fit well with demand, because the Quebec market is holding steady in a position of equilibrium. Apartments that were recently built are renting well. The demand is there, especially from households that cannot afford to become homeowners.

In Ontario, the boom in rental apartment construction has just got started. The market has never really been in a surplus position since the end of the 1980s, so there are few lessons to be learned from the past. In any event, condos are still popular thanks to investors who are stimulating demand for this product by offering a significant volume of units for rent. This satisfies a portion of the demand for

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Box 1
A balanced rental market

"It is generally accepted that the rental housing market is in a balanced state when approximately 3% of the inventory of rental units is vacant. In these conditions, the vast majority of landlords manage to rent out their units, and renters are able to find a home within a reasonable length of time. A vacancy rate above the equilibrium level of 3% generally has a negative impact on landlords, who then face greater competition for renting out their units. On the other hand, a vacancy rate below the equilibrium level of 3% makes it more difficult for renters to find a home and can consequently put upward pressure on rents."[1]

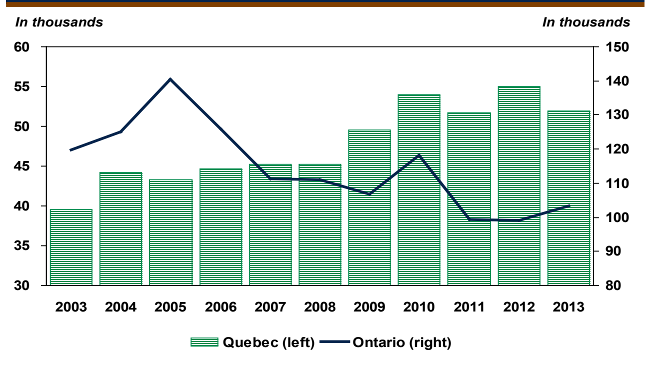
1 Translated excerpt from: Communauté métropolitaine de Montréal, "Disponibilité des logements locatifs : hausse du taux d'inoccupation malgré une pénurie récurrente dans certains secteurs", *Perspective Grand Montréal*, bulletin nº 23, June 2013, http://cmm.qc.ca/fileadmin/user_upload/periodique/23_Perspective.pdf.

conventional rental housing, thus limiting the development potential of this market in the province. It should be noted that Ontario's rental housing vacancy rate rose to 2.8% in the spring because international migration, which usually fuels demand, has dropped off in that province.

INTERNATIONAL IMMIGRATION PLAYS A KEY ROLE

Population movements have a direct influence on the rental market. People who have just arrived in a city or a province tend to rent an apartment. Thus migration from foreign countries has a strong impact on the rental market. According to Statistics Canada[2], nearly all new immigrants opt for rental housing when they settle in this country, and keep renting for four years or so after their arrival. But international immigration is in decline in Ontario. Ten years ago, the province attracted around 125,000 foreigners annually, but in the past few years that number has been close to 100,000. Back then, Ontario attracted over 50% of newcomers to Canada, whereas that proportion now stands at around 40%. Meanwhile, Quebec's share of immigration has risen to 20%, consisting of over 50,000 international immigrants annually. The average age of newcomers is 28. The retention rate has even increased over the years, since 80% of newcomers are still living in Quebec after two years.[3] The fact that the province has raised its immigration targets in recent years has had an impact. International migration is now hovering around 50,000 persons per year (graph 2), and this is stimulating the rental market.

Graph 2 – In the past 10 years, international immigration has increased in Quebec and contracted in Ontario



Sources: Statistics Canada and Desjardins, Economic Studies

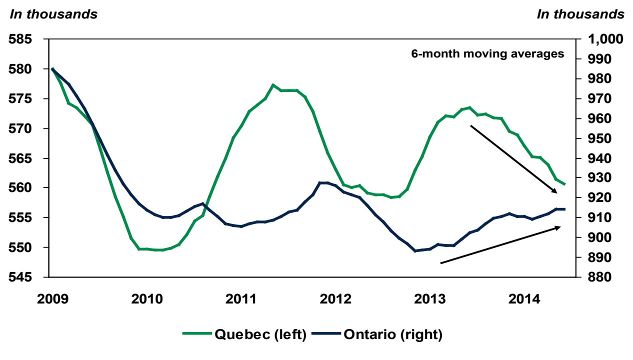
THE INFLUENCE OF YOUTH

Young households also constitute a significant segment of the rental clientele. Consequently, the labour market, especially employment trends among those between the ages of 15 and 24, constitutes a good indicator of demand for apartments. This factor seems to have stimulated rental demand in Ontario since last year, but this is not necessarily the case in Quebec. In Ontario, the number of young workers has risen sharply in the past year, whereas the reverse is true in Quebec (graph 3 on page 3). The labour market has been struggling since the beginning of 2014, and the number of jobs among those aged 15 to 24 has dropped. However, several projects aimed at students have been started recently. In Quebec, new construction has started close to the university campus. In Montreal, the conversion of three former downtown hotels into student residences will eventually add nearly 2,000 units to the market. This will increase the risk for this specific market, as the student renter population is not necessarily growing briskly.

2 Statistics Canada, *Longitudinal Survey of Immigrants to Canada*, http://www23.statcan.gc.ca/imdb/p2SV.pl?Function=getSurvey&SDDS=4422

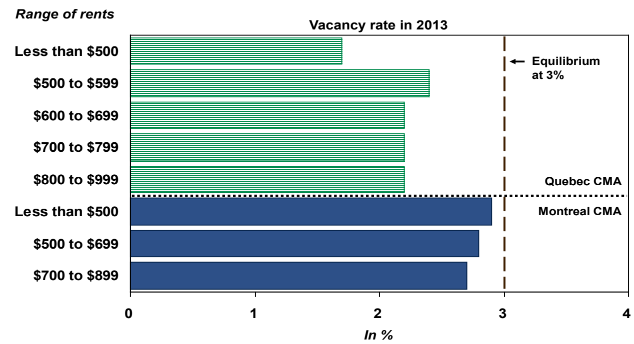
3 Institut de la statistique du Québec, « Le bilan démographique du Québec », *Statistics and Publications – Population and demography*, Gouvernment of Quebec, Edition 2013, December 3, 2013, http://www.stat.gouv.qc.ca/statistiques/population-demographie/bilan-demographique_an.html

Graph 3 – Employment among youth aged 15 to 24 is doing well in Ontario but has been declining in Quebec in the past year



Sources: Statistics Canada and Desjardins, Economic Studies

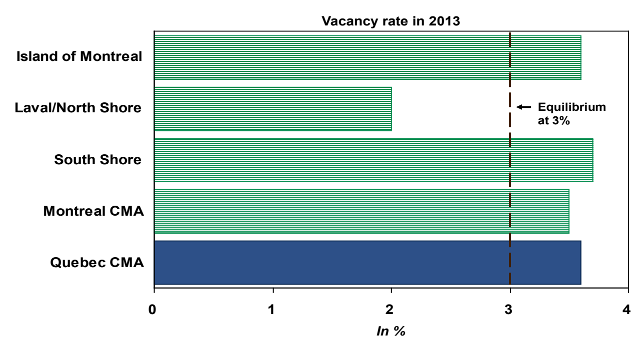
Graph 4 – Montreal and Quebec CMAs: Low vacancy rates for low-end and medium-range rental units



CMA: census metropolitan area
Sources: Canada Mortgage and Housing Corporation and Desjardins, Economic Studies

While demand for rental units aimed at young people has declined in Quebec, demand from somewhat older households has taken up the slack. People buying their first homes are usually between the ages of 25 and 44. Given that home ownership is presenting a greater challenge, this cohort is increasingly turning to rental properties and supporting demand for apartments. Those between the ages of 15 and 24 tend to rent less expensive properties, while those between 25 and 44 can generally afford higher rents. Therefore, the new builds in Quebec are aiming primarily at meeting demand for rental apartments that offer an alternative to home buying. In any event, the vacancy rate is quite similar in all the price ranges in both Greater Montreal and Quebec (graphs 4 and 5), with the exception of the higher end of the market[4].

Graph 5 – Montreal and Quebec CMAs: No significant surplus of high-end rental units*

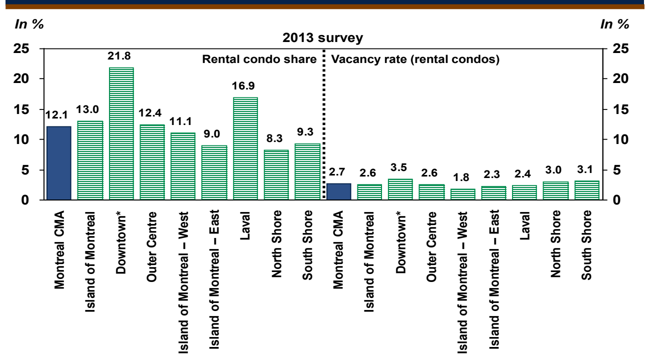


CMA: census metropolitan area; * Rents > $900 in Montreal and > $1,000 in Quebec City.
Sources: Canada Mortgage and Housing Corporation and Desjardins, Economic Studies

COMPETITION FROM CONDOMINIUMS

Although the situation is relatively good for conventional luxury rental apartments, the rental condominium market is drawing away a growing share of the client pool. The average rent is quite similar, and condo fees are generally borne by the property owner. Rental units are usually owned by investors or developers who have not managed to sell all their recently built condominium units. The proportion of units available for rent stands at 12.1% in the Montreal census metropolitan area (CMA), 21.8% in the downtown core and over 15% in Laval (graph 6). The vacancy rate varies between 2% and 3% in most areas but is higher in downtown Montreal. In Toronto and Ottawa, about a quarter of condos are rented out, while the vacancy rates stand at 1.8% and 3.6%, respectively (graph 7 on page 4). In the Quebec CMA, nearly 10% of all units are for rent and the vacancy rate is relatively high (graph 8 on page 4).

Graph 6 – Montreal CMA: Rental condo market

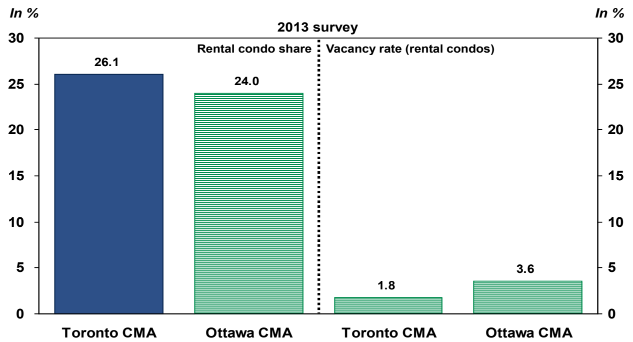


CMA: census metropolitan area; * Includes Nun's Island.
Sources: Canada Mortgage and Housing Corporation and Desjardins, Economic Studies

Renting a condo is an attractive option for both young households who prefer to live in recently built homes without having to buy, and older households who have left their single-family homes. To attract and retain their clients, the owners of traditional rental properties must distinguish themselves through unparalleled service and sound building maintenance.

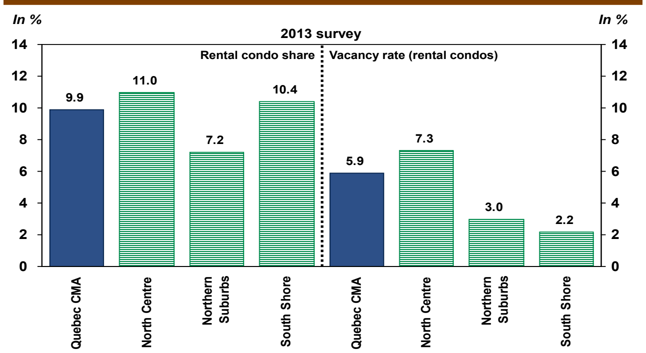
[4] A monthly rent of over $900 in Montreal and over $1,000 in Quebec. Given that the average rents in Quebec are more expensive than those in Montreal, the price range of high-end rental units is also higher.

Graph 7 – Toronto and Ottawa CMAs: Rental condo market



CMA: census metropolitan area
Sources: Canada Mortgage and Housing Corporation and Desjardins, Economic Studies

Graph 8 – Quebec CMA: Rental condo market



CMA: census metropolitan area
Sources: Canada Mortgage and Housing Corporation and Desjardins, Economic Studies

The competition between high-end rentals and condos (both purchased and rented) is expected to intensify even further in Montreal. Following a lull last year, construction of condominium units has picked up once again, especially in the downtown core, even though the market is already experiencing a surplus and prices are stagnating. In Quebec CMA, condo starts are still declining this year, a situation that should help stabilize the market and keep a rein on renting. In Ontario, construction has declined for a second consecutive year in Ottawa, while Toronto is experiencing a slight recovery. Competition from rental condos is sure to be a factor in the province for some time.

THE INVESTOR'S POINT OF VIEW

Investing in rental properties is still popular. In addition to regular rental income, investors are motivated by the prospect of an increase in property value, especially against a backdrop of low interest rates. Investors must be patient, however, because there are few good buying opportunities. High prices have led to a decline in capitalization rates, a performance indicator that gauges the income generated by a building in proportion to its purchase price. The fact that building prices are rising faster than rents must also be taken into consideration. As a result, capitalization rates continue to fall, constantly reaching new lows. Investors should pay close attention to the risk of acquisition, opting for high-quality buildings that will continue to be well regarded. Buildings must be well maintained because major investments are often difficult to make, given the low rents in Quebec. For this reason, buyers usually opt for recent constructions. Concrete buildings are in high demand, while buildings made of wood and brick, which are more outdated, are generally passed over. Investors must be very selective when purchasing properties because they can be very expensive.

THE RENTAL MARKET: CHALLENGES AND OUTLOOK

Even though this market is doing well (see box 2 on page 5) and the pace of construction is picking up, there are a number of challenges on the horizon. Quebec's rental properties are aging, leading to greater competition between older and younger buildings. Demand for new properties is considerable, and maintenance will play a decisive role when it comes to older buildings' ability to keep their tenants. With rents rising slowly, owners sometimes find it difficult to secure the financial means to make necessary improvements. If the required investments are not made, older buildings will find it harder and harder to maintain their position in the market. Facing increased competition from new apartments, the appeal of older buildings may decline even further in coming years.

What client groups should be the focus? First, young households that do not have the financial capacity to acquire their own home, and second, older clients. The aging population represents an opportunity for three types of products: condominiums (purchased or rented), conventional rental properties and seniors' residences, of which there has however been a substantial surplus on the market for a few years. Well-located and well-maintained rental properties that provide quality services to tenants will be able to capitalize on demographic trends. Demand for rental units is expected to rise in the coming years. If the pace of new construction gradually adjusts to meet demand, the vacancy rate should remain near the equilibrium level of 3% in Quebec. In Ontario, new construction will continue to be limited because the constant growth in the number of rental condos, a result of the greater presence of owner-investors, will further erode the client base for rental properties. The higher demand, met in part by the greater number of rental condos, combined with the scarcity of conventional rental apartment construction projects, will keep the vacancy rate at about 3% in Ontario.

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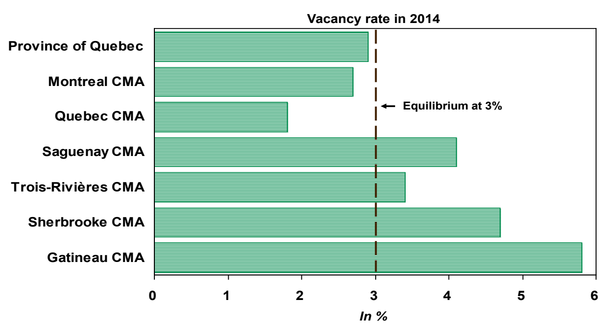
Box 2
Regional disparities

Even though the Quebec market is close to being balanced, four of the six metropolitan regions are experiencing a surplus (graph A), namely Saguenay, Trois-Rivières, Sherbrooke and Gatineau. Supply is tighter in the Montreal and Quebec CMAs, where housing starts are also concentrated. Over the last year, rents have climbed by about 2% in most CMAs (graph B). They are highest in Quebec, followed by Gatineau and Montreal CMAs. Rental market players must therefore take the specific characteristics of each market into account. Some areas offer good potential for growth while others are already saturated, making development a riskier prospect.

In Ontario, most markets show a vacancy rate near the 3% equilibrium point (graph C), while the Toronto market's vacancy rate is low, at 1.9%, signalling a slight shortage. Although rental apartment construction showed solid growth over the first half of 2014, condo starts continue to dominate, with construction starting on roughly 8,282 units in the first six months of the year compared to 726 traditional rental units. In addition, the condo rental market meets the demand for apartments rather well, reducing pressure on the conventional rental market. The rental market is balanced in Ottawa, and construction activity is very limited. Since the number of rental condos has risen, many tenants are turning to this market for their housing needs.

Graph A – Some markets are experiencing a surplus while others a slight shortage



CMA: census metropolitan area
Sources: Canada Mortgage and Housing Corporation and Desjardins, Economic Studies

Graph B – Quebec's rents by CMA in 2014

	Level	Variation
Saguenay	$537	2.0%
Montreal	$721	2.6%
Gatineau	$722	Stable
Quebec	$735	1.6%
Sherbrooke	$578	1.9%
Trois-Rivières	$542	1.3%
Quebec total	$689	2.3%

CMA: census metropolitan area
Sources: Canada Mortgage and Housing Corporation and Desjardins, Economic Studies

Graph C – Ontario's vacancy rate and rents by CMA in 2014

	Vacancy rate	Average rent	Variation
Greater Sudbury	5.0%	$871	n/a
Hamilton	3.9%	$880	2.8%
Kingston	3.4%	$987	2.9%
Kitchener	3.6%	$913	3.0%
London	3.6%	$850	1.6%
Oshawa	1.6%	$974	3.0%
Ottawa	3.2%	$1,013	0.9%
St. Catharines–Niagara	3.8%	$843	2.1%
Thunder Bay	2.4%	$801	3.2%
Toronto	1.9%	$1,143	2.5%
Windsor	5.0%	$706	1.8%
Ontario total	2.8%	$1,011	2.3%

n/a: not available
Sources: Canada Mortgage and Housing Corporation and Desjardins, Economic Studies